

ST 98-15

Tax Type: SALES TAX

Issue: Interim Use Exemption

**STATE OF ILLINOIS
DEPARTMENT OF REVENUE
OFFICE OF ADMINISTRATIVE HEARINGS
CHICAGO, ILLINOIS**

THE DEPARTMENT OF REVENUE)	Docket No.
OF THE STATE OF ILLINOIS)	Reg. No.
v.)	NTL No.
TAXPAYER)	
)	John E. White,
Taxpayer.)	Administrative Law Judge

RECOMMENDATION FOR DISPOSITION

Appearances: Thomas Donohoe, McDermott, Will & Emery, for
TAXPAYER John Alshuler, Special Assistant
Attorney General, for the Illinois Department of
Revenue.

Synopsis:

The Illinois Department of Revenue ("Department") issued a Notice of Tax Liability ("NTL") to TAXPAYER ("TAXPAYER" or "taxpayer") which assessed Illinois use tax following an audit of TAXPAYER's business regarding the period beginning July 1, 1990 through June 30, 1993. TAXPAYER protested that NTL, and requested a hearing.

Pursuant to a pre-hearing order, the parties agreed that the issue to be resolved was whether TAXPAYER was a retailer or a lessor of aerial lift equipment for purposes of determining whether TAXPAYER can claim benefit of the interim use and demonstration exemption from use tax. At hearing, TAXPAYER introduced documentary evidence consisting of its books and records, as well as the testimony of four witnesses, including the Department's auditor. I have considered the evidence adduced at hearing, and I am including in this recommendation findings of fact and

conclusions of law. I recommend the issue be resolved in favor of the Department.

Findings of Fact:

1. TAXPAYER is a Wisconsin corporation that has an office in FICTITIOUS CITY, Illinois. *See* Department Ex. 1; Taxpayer Ex. 6.
2. TAXPAYER's "principal activities consist of the rental and sale of aerial lift equipment and related parts and service sales for construction and industrial use." Taxpayer Ex. 7 (audited financial statements for 1990-91), p. 8 (note 1(a) (Nature of Business); Hearing Transcript ("Tr.") p. 27 (testimony of JOHN DOE ("DOE"), vice president and secretary for TAXPAYER).
3. Aerial lift platforms are machines designed to lift persons to certain heights for work on or around high objects, buildings, etc. *See* Tr. pp. 24-26 (DOE); Taxpayer Exs. 4-5. Contractors, industry, institutions, hospitals, retailers, and others use aerial work platforms. *See* Taxpayer Ex. 13; Tr. p. 26 (DOE).
4. TAXPAYER is an authorized distributor for certain manufacturers of aerial work platforms who have granted TAXPAYER the right to sell and provide service on the manufacturers' lines of aerial work platforms in a designated area. Taxpayer Exs. 1-3; Tr. pp. 27-29 (DOE).
5. Each platform in TAXPAYER's sales inventory and in its rental fleet bears a unit or serial number by which that particular item might be specifically identified. *See* Taxpayer Exs. 5-6, 18-19.
6. TAXPAYER did not pay use tax to the persons from whom it purchased aerial platforms. Tr. p. 85 (DOE). Instead, it gave resale certificates to the manufacturers from whom it purchased new platforms, and to the vendors from

- whom it purchased the platforms it put into its rental fleet. *See* Tr. p. 53 (DOE).
7. TAXPAYER treats its inventory of new platforms it holds for resale (i.e., its “sales inventory”) differently than it does its fleet of platforms that are available for rental to customers (i.e., its “rental fleet”). *See* Taxpayer Ex. 7, p. 3; Taxpayer Ex. 8, p. 4.
 8. TAXPAYER keeps the new platforms it purchases from manufacturers separate from the platforms it puts into its rental fleet. Taxpayer Ex. 4; Tr. pp. 48-50 (DOE).
 9. TAXPAYER does not make its sales inventory available for rental to customers. Tr. pp. 48-50 (DOE); *see also* Taxpayer Ex. 5.
 10. TAXPAYER treats its sales inventory as a current asset of the corporation, and identifies the value of such assets under the description “Equipment held for resale” in its financial statements. Taxpayer Ex. 7, pp. 3, 6, 8; Taxpayer Ex. 8, pp. 4, 10 (esp. note 1(f) of each financial statement). TAXPAYER did not depreciate its current assets, including its inventory of new platforms it held for resale. Taxpayer Ex. 7, p. 3; Taxpayer Ex. 8, p. 4.
 11. TAXPAYER depreciates the platforms in its rental fleet. Taxpayer Ex. 7, pp. 3, 8; Taxpayer Ex. 8, pp. 4, 10. Specifically, TAXPAYER classifies its fleet of rental platforms as part of its property and equipment, on which it takes an allowance for depreciation for federal tax purposes. Taxpayer Ex. 7, pp. 3, 8 (note 1(b)); Taxpayer Ex. 8, pp. 4, 10 (note 1(b)).
 12. TAXPAYER’s financial statements include the following notes to explain, in part, its classification and treatment of its rental fleet:

(b) Property and Equipment

Property and equipment are stated at cost. Depreciation is computed using the straight-line method for financial statement purposes and accelerated methods for tax purposes. The Company assigns a 20% residual value to all rental equipment and 10% to all other equipment. The net book value, after assignment of residuals, is being depreciated over the remaining estimated useful lives of the equipment.

* * *

(d) Rental Fleet Classification

For the years 1991 and 1990, the Company has sold approximately 25% of its rental fleet. It is Company policy to record any asset placed in service as a long-term asset for reporting purposes and none of these assets have been classified as current assets.

Taxpayer Ex. 7, p. 8; Taxpayer Ex. 8, p. 10 (note 1(d) of each statement).

13. About 75% of the platforms in TAXPAYER's rental fleet are not sold in two years. *See* Taxpayer Ex. 7, p. 8; Taxpayer Ex. 8, p. 10 (note 1(d) of each statement). TAXPAYER, therefore, keeps about 50% of its rental fleet available for rental to customers for four years. *Id.*; *see also* Taxpayer Ex. 19 (the average age of the platforms in TAXPAYER's rental fleet as of 6/30/93 was 45 months, assuming the size of the rental fleet was accurately determined). As of the last date of the audit, TAXPAYER had owned 54 of the platforms in its rental fleet for longer than five years, and sixteen of those platforms for longer than nine years. Taxpayer Ex. 19 (item numbers 1-54).
14. In 1990, TAXPAYER reported that \$2,764,713 of its assets placed in service¹ was attributable to the value of its rental fleet, and reported that \$20,770 of its

¹ The period for depreciation of an asset begins when the asset is placed in service and ends when the asset is retired from service. 26 C.F.R. § 1.167(a)-10(b); *see also* 26 C.F.R. § 1.167(a)-(11)(e)(1) (definition of the term "first placed in service").

- current assets were attributable to its sales inventory. Taxpayer Ex. 7, p. 3. In 1991, TAXPAYER reported that \$2,807,336 of its assets placed in service were attributable to its rental fleet, and reported that \$93,828 of its current assets were attributable to its sales inventory. *Id.*; *see also* 26 C.F.R. § 1.167(a)-(11)(e)(1).
15. In 1992, TAXPAYER reported that \$3,020,808 of its assets placed in service were attributable to its rental fleet, and reported that \$135,085 of its current assets were attributable to its sales inventory. Taxpayer Ex. 8, p. 4. In 1993, TAXPAYER reported that \$2,725,952 of its assets placed in service were attributable to its rental fleet, and reported that \$144,880 of its current assets were attributable to its sales inventory. *Id.*
16. TAXPAYER classified its platform rentals, its sales of new platforms, and its sales of parts and service as its operational activities. Taxpayer Ex. 7, pp. 5-6; Taxpayer Ex. 8, pp. 8, 10.
17. TAXPAYER did not classify its sales of platforms from its fleet of rental equipment as an operational activity. Taxpayer Ex. 7, p. 6; Taxpayer Ex. 8, p. 8. Instead, TAXPAYER classified the revenue it received from such sales as cash flows from an investing activity. *Id.*
18. In 1990, when TAXPAYER earned \$2,260,426 from renting platforms, it earned \$96,287 from selling its used rental platforms. Taxpayer Ex. 7, pp. 5-6. In 1991, TAXPAYER earned \$2,220,669 (or \$2,188,994, *see* Taxpayer Ex. 12) from renting platforms, and \$187,890 from selling its used rental platforms. *Id.* In 1992, TAXPAYER earned \$1,989,018 (or \$1,964,682, *see* Taxpayer Ex. 12) from renting platforms, and \$209,339 from selling its used rental platforms. Taxpayer

- Ex. 8, pp. 6, 8. In 1993, TAXPAYER earned \$2,036,058 (or \$1,996,654, *see* Taxpayer Ex. 12) from renting platforms, and \$264,481 from selling its used rental platforms. Taxpayer Ex. 8, pp. 6, 8.
19. TAXPAYER filed returns with the Department during the audit period on which it paid retailers' occupation tax regarding its sales of platforms. *See* Department Ex. 1, line 14.

Facts Regarding the Department's Audit

20. During an audit of TAXPAYER's business, the Department assessed use tax on TAXPAYER's purchases of tangible personal property, to wit: aerial lift platforms, which TAXPAYER made available for rental to customers in Illinois. Department Ex. 1, line 12.
21. The Department's auditor determined that TAXPAYER was primarily engaged in the business of renting platforms after comparing TAXPAYER's gross revenues from rentals during the audit period with its gross revenues from selling aerial work platforms and related parts and services. Tr. p. 105 (Sholtes).
22. The Department's comparison of TAXPAYER's rental versus sales revenues showed that TAXPAYER earned over 50% of its revenues from renting platforms. Taxpayer Ex. 12; *see also* Department's Post-Hearing Brief ("Department's Brief"), p. 2; Tr. p. 13 (during its opening statement, counsel for the Department indicated that the Department determined TAXPAYER was primarily engaged in the business of renting aerial work platforms).
23. The levels of TAXPAYER's rental and sales revenues used by the auditor were obtained from TAXPAYER's own audited financial statements, wherein

TAXPAYER reported that it earned the following revenues from the following operations:

REVENUE SOURCE	1990	1991	1992	1993*
equipment rentals	2,260,426	2,220,669	1,989,018	2,036,058
equipment sales	1,212,746	1,169,691	1,285,671	1,237,065
parts & service sales	984,511	797,142	657,980	737,315
TOTAL FROM SALES **	2,197,257	1,966,833	1,943,651	1,974,380

Taxpayer Ex. 7, p. 5; Taxpayer Ex. 8, p. 4 (*The 1993 figures detailed in Taxpayer Ex. 8 were described as being unaudited.) (**The entries on this table labeled “TOTAL FROM SALES” were not included within TAXPAYER’s financial statements, and merely total TAXPAYER’s annual revenues from total sales for comparison with its annual revenues from rentals.); *see also* Taxpayer Ex. 12.

24. TAXPAYER introduced restated estimates of its rental versus sales revenues to rebut the Department’s auditor’s determination that it was primarily engaged in the business of renting platforms. Taxpayer Ex. 12; Taxpayer’s Brief, pp. 13-17.
25. Even using TAXPAYER’s restated rental revenues for the audited years, approximately half of TAXPAYER’s total revenues during the audited years were derived from TAXPAYER’s business of renting platforms to customers. *See* Taxpayer Ex. 12 (restated rental revenues made up approximately 52% of TAXPAYER’s total revenues for 1991, 49.9% of its total revenues for 1992, and 49.7% of its total revenues for 1993).
26. TAXPAYER prepared a rental agreement and/or an invoice when it rented an item of aerial lift equipment, or when it provided service to a customer. *See* Taxpayer Exs. 6, 13. TAXPAYER introduced a single rental agreement to

support its claim that the equipment in its rental fleet was rented primarily to promote, demonstrate, or as an incident to its business of selling the new aerial lift equipment it held for resale. Taxpayer Ex. 6.

Conclusions of Law:

This case involves the interplay of the Retailers' Occupation Tax Act ("ROTA") and the Use Tax Act ("UTA") as they pertain to a person engaged in the business of both selling and renting tangible personal property in Illinois.

The UTA imposes a tax "upon the privilege of using in this State tangible personal property purchased at retail from a retailer" 35 **ILCS** 105/3. The General Assembly defined certain terms used within the UTA in § 2 of that act. 35 **ILCS** 105/2.

It defined "use" as:

the exercise by any person of any right or power over tangible personal property incident to the ownership of that property, except that it does not include the sale of such property in any form as tangible personal property in the regular course of business to the extent that such property is not first subjected to the use for which it was purchased, and does not include the use of such property by its owner for demonstration purposes. ... "Use" does not mean the demonstration use or interim use of tangible personal property by a retailer before he sells that tangible personal property. ***

35 **ILCS** 105/2.

The legislature defined "retailer" as "every person engaged in the business of making sales at retail as defined in this Section." *Id.* The UTA's definition of a "sale at retail" is consistent with the definition of the same term in the ROTA. *Compare* 35 **ILCS** 105/2 *with* 35 **ILCS** 120/1.

A person engaged in the business of leasing or renting tangible personal property

to others in Illinois is the legal “user” of the property it purchases and makes available for lease in Illinois. Telco Leasing, Inc. v. Allphin, 63 Ill. 2d 305, 311 (1965). The right or power exercised by a lessor incident to its ownership of the property it leases “is the right or power to lease the property in an attempt to make a profit.” *Id.*, 63 Ill. 2d at 310 (*citing Philco Corp. v. Department of Revenue*, 40 Ill.2d 312).

Section 306 of the Department’s use tax regulations provides, in part:

- a) Interim Use Exemption
 - 1) Tangible personal property purchased by a retailer for resale, and used by the retailer or his agents prior to its ultimate sale at retail, is exempt from Use Tax, provided that the tangible personal property is carried as inventory on the books of the retailer or is otherwise available for sale during the interim use period.
 - 2) The leasing of tangible personal property by persons who are primarily engaged in the business of selling such property at retail is within the interim use exemption if such property is carried as inventory on the books of the retailer or is otherwise available for sale during the lease period. The interim use exemption is not available to persons who purchase tangible personal property with the intent to engage in the business of leasing such property and who sell such property only as an incident to their leasing activity. ***

86 Ill. Admin. Code § 150.306(a) (adopted 1984).

The *prima facie* correctness of the Department's action in this matter was established when the Department introduced its correction of TAXPAYER’s returns under the certification of the Director. 35 ILCS 120/4. The Department's *prima facie* case is overcome, and the burden shifts to the Department to prove its case, when a taxpayer presents evidence that is consistent, probable and identified with its books and records, to show that the Department’s corrected returns are not correct. Copilevitz v.

Department of Revenue, 41 Ill. 2d 154, 156-57 (1968).

Despite the parties' agreement as to the issue, taxation in this matter does not turn on whether TAXPAYER is "primarily" a retailer, or "primarily" a renter. See Illinois Road Equipment Co. v. Department of Revenue, 32 Ill. 2d at 580. Arguing the primacy of TAXPAYER's two principle business activities (*see* Taxpayer Ex. 7, p. 8; Taxpayer Ex. 8, p. 10 (note 1 (a) of each exhibit)), without reference to the specific property on which tax was assessed here,² skirts the real issue. Resolving whether or not use tax was properly assessed here requires a review of facts probative to show primary TAXPAYER's primary status vis-a-vis *the property at issue*, i.e., the property on which tax was assessed.³

² In this recommendation, I will refer to the tax as having being assessed on equipment in TAXPAYER's rental fleet, although tax is actually imposed on the privilege of using that tangible personal property in Illinois (35 ILCS 105/3), and is measured as a percentage of TAXPAYER's purchase price for such property. 35 ILCS 105/3-10.

³ For purposes of interim use questions, annual fluctuations in comparative revenues the taxpayer receives from either selling or renting property ought not, like some *post hoc* toggle switch, render the taxpayer either eligible or ineligible for the exemption.

TAXPAYER's chief financial officer described the clearly untenable predicament in which such a taxpayer would find itself, if taxability or exemption of purchases turned on how much money it made over the course of a year from each different business activity— a review which could not occur until months after the purchases were made. Tr. pp. 85-86 (DOE). Specifically, DOE testified as follows:

Q: At the beginning of a year, are you as a business person able to know what the ratio of rentals to sales will be in any given period?

A: I would say it's virtually impossible to make any kind of a decision like that at the start of a year. Accordingly, whatever we do for a given year in advance of the year and through the year is just almost a toss of the coin. It makes my job as a chief financial officer virtually impossible because in one breath it looks like sales are higher than rentals so I should be not reporting use tax on equipment put into the rental.

Then in another case sales are higher [sic] so I paid some tax that I shouldn't have paid. It's really a really difficult situation as I pointed out to Mr. Sholtes when he finished the audit. ***

TAXPAYER does not dispute that use tax was assessed on TAXPAYER's purchases, during the audit period, of aerial lift equipment it made available for rental to customers in Illinois. TAXPAYER's Brief, p. 2; *see also* Department Ex. 1. Therefore, the issue to be resolved here is whether TAXPAYER primarily "used" those platforms, or whether TAXPAYER exercised power or control over those platforms which was merely incidental to TAXPAYER's business of selling those aerial platforms (i.e., did it exercise an "interim use" of those platforms prior to selling them).

At hearing, TAXPAYER principally challenged the way the Department determined that TAXPAYER was "primarily" a lessor, by referring to evidence in the record to show that its primary focus was on selling platforms. *See, e.g.*, Taxpayer Ex. 12; *see also* TAXPAYER's Brief, pp., 13-17. In its brief, TAXPAYER cites to Illinois Road Equipment Co. v. Department of Revenue, 32 Ill. 2d 576, 580 (1965) for the proposition that a retailer's rentals of property it sells can be a non-taxable interim use of the property where the rentals "were simply a method used to demonstrate and promote the sale of machinery." TAXPAYER's Brief, p. 12 (*citing* Illinois Road Equipment Co.). I agree. But those are not the facts as established by the evidence introduced regarding TAXPAYER's business activities and its treatment of the property on which tax was assessed here.

Instead, what the documentary evidence established, and what TAXPAYER

Tr. p. 85 (DOE) (emphasis added). Mr. DOE was obviously speaking hypothetically in his testimony highlighted above. In fact, TAXPAYER never paid use tax regarding its purchases of platforms for use in its rental fleet. Tr. p. 85 (DOE). Instead, it gave resale certificates to its vendors regarding all of its purchases of rental platforms. *See* Tr. p. 53 (DOE).

It would not be virtually impossible, however, for TAXPAYER to remit to its Illinois vendors use tax when it purchased the equipment it knew it would make available for rental to

cannot seriously contest, is that TAXPAYER conducts two businesses — it sells and it rents similar, but not identical, tangible personal property. Moreover, and despite TAXPAYER’s argument to the contrary (*see* TAXPAYER’s Brief, p. 12), the evidence shows that TAXPAYER’s rental business was a separate and distinct business activity in which it engaged. *See generally* Taxpayer Exs. 7-8. TAXPAYER’s own financial statements show that TAXPAYER rented platforms for the very rational purpose of making money on such rentals. *Id.*; *see also* Telco Leasing, Inc., 63 Ill. 2d at 310; Illinois Road Equipment Co., 32 Ill. 2d at 580.

TAXPAYER’s own books and records show that it conducted two principal business activities, and that it conducted those separate business activities distinctly. To begin, TAXPAYER itself has identified what activities it considers to be part of its business operations. TAXPAYER described as “cash flows from operating activities” the net earnings it received from renting platforms, from selling new platforms, and from selling parts and services. Taxpayer Ex. 7, pp. 5-6; Taxpayer Ex. 8, pp. 8, 10. In contrast, TAXPAYER classified the revenues it received from selling its rental equipment as cash from an investing activity. Taxpayer Ex. 7, p. 5; Taxpayer Ex. 8, p. 8.

The crux of TAXPAYER’s claim at hearing is that when it rented the equipment it put into its rental fleet, that exercise of power and control constituted a mere “interim use” of the property, because it purchased the equipment intending to hold it for resale. *See* TAXPAYER’s Brief, p. 2 (“[TAXPAYER] purchased its equipment for resale and did not self-assess Illinois Use Tax on the equipment made available for rental because it intended to resell the equipment and thus qualified for the interim use exclusion from the

customers as part of its rental business, or to file returns with the Department and self-assess the

use tax.”) TAXPAYER’s own written statements that its business operations include renting platforms, but do not include selling the platforms it put into its rental fleet, however, shows that TAXPAYER’s sales of its rental platforms were actually incidental to its rental operations, instead of *vice-versa*. See Howard Worthington, Inc. v. Department of Revenue, 96 Ill. App. 3d 1132, 1137 (2d Dist. 1981) (use tax properly paid on lessor’s use of tangible personal property purchased for purpose of making it available for lease to others, and subsequent sale of the property by lessor was also properly subject to ROT).

Additionally, TAXPAYER kept its sales inventory of new aerial lift equipment separate from its rental fleet. Taxpayer Ex. 4; Tr. pp. 45-46 (DOE). TAXPAYER didn’t mingle its sales inventory and its rental fleet because it never intended to rent the new equipment it purchased and held for resale. See Tr. pp. 48-50 (DOE); Taxpayer Ex. 5 (photo of inventory control board at TAXPAYER’s office showing sales and rental units). Because its distributorship agreements required TAXPAYER to begin making payments on any unsold new platforms still in TAXPAYER’s inventory six months after the date of delivery, TAXPAYER strove to sell each new platform within six months of delivery. Tr. pp. 55-56 (DOE); *see also* Taxpayer Ex. 18; Tr. p. 105 (Sholtes).⁴

use tax regarding such purchases.

⁴ Despite its title, Taxpayer Exhibit 18 is actually a tally of the total number of platforms TAXPAYER sold during the audit period, and not just a tally of the rental units it sold during the audit period. Tr. p. 105 (Sholtes).

If TAXPAYER really sold 442 of 616 rental units during the 3 year audit period (sum of units counted in Taxpayer Exs 18-19), that sales activity would constitute a sales rate closer to 71% of its rental fleet over a three year period. That sales rate is grossly inconsistent with TAXPAYER’s own reports that it sold approximately 25% of its rental equipment every two years (*see* Taxpayer Ex. 7, p. 8; Taxpayer Ex. 8, p. 10 (note 1(d) of each statement)), and was likely skewed by lumping together both new and rental platforms into one category. Taxpayer Ex. 18.

Consistent with its status vis-a-vis that property, TAXPAYER carried its sales inventory on its books as its “equipment held for resale,” and did not depreciate those platforms. Taxpayer Ex. 7, pp. 3, 6, 8; Taxpayer Ex. 8, pp. 4, 10; *see also* 26 C.F.R. § 1.167(a)-2. TAXPAYER was exclusively a retailer, and not a lessor, of the new aerial lift equipment it purchased from manufacturers and held for resale.

In contrast, TAXPAYER was not exclusively, or even primarily, a retailer of the platforms in its rental fleet. TAXPAYER sold only about 25% of its rental fleet every two years. Taxpayer Ex. 7; p. 8; Taxpayer Ex. 8, p. 10 (note 1 (d) of each exhibit)). That means that TAXPAYER did not sell about 75% of its rental equipment for two years. It also means that after four years, TAXPAYER likely would have sold approximately 50% of its rental fleet, and that it would have kept the other half of the platforms in its rental fleet. At the end of the audit period, the average age of the platforms included in TAXPAYER’s rental fleet was 45 months. Taxpayer Ex. 19. Over fifty of the platforms in TAXPAYER’s rental fleet had been owned and made available for rental by TAXPAYER for over 5 years, and 16 of them had been owned and rented by TAXPAYER for over 9 years. *Id.*⁵ Using the language of use tax rule 306(a)(2), TAXPAYER’s rentals did not involve “[t]he leasing of tangible personal property by [a] person[] who [was] primarily engaged in the business of selling *such property* at retail” 86 Ill. Admin. Code § 150.306(a)(2) (emphasis added).

Besides making the platforms in its rental fleet available for rental for at least two

⁵ As an adjective, the word “interim” means “for or during an interim; temporary; provisional [an *interim* council].” Webster’s New World Dictionary 734 (2d College Ed.) (1978). The age of the platforms in TAXPAYER’s rental fleet begs the question — could the legislature have really intended retailers to enjoy nine years of profitable business use of tangible personal property as an *interim* use of such property?

years (*see* Taxpayer Ex. 7, p. 8; Taxpayer Ex. 8, p. 10 (note 1(d) of each statement)), and on average, even longer (*see* Taxpayer Ex. 19), TAXPAYER also depreciated them. Taxpayer Ex. 7, pp. 3, 8; Taxpayer Ex. 8, pp. 4, 10. At hearing, TAXPAYER's chief financial officer testified that even though TAXPAYER might depreciate an item of tangible personal property on its books, it would not take a credit or deduction on its federal returns regarding equipment kept in its inventory less than one year. *See* Tr. p. 92 (Hollman). That certainly may be the case regarding TAXPAYER's sales inventory. 26 C.F.R. §§ 1.167(a)-1, (a)-2; *see also* [1994] 3 Stand. Fed. Tax Rep. (CCH) ¶ 11,004.01, at 25,521 (Property is depreciable if it (1) is used for business or held for the production of income; (2) has a determinable useful life exceeding one year; and (3) wears out, decays, becomes obsolete, or loses value from natural causes). Here, however, tax was assessed on equipment TAXPAYER purchased during the audit period and put into its rental fleet. There is no dispute that TAXPAYER depreciated its entire rental fleet. Taxpayer Ex. 7, pp. 3, 8; Taxpayer Ex. 8, pp. 4, 10.

The Department argues that since the equipment at issue was depreciated, those platforms cannot be considered to have been carried as inventory on TAXPAYER's books. *See* Department's Response, pp. 2-3. TAXPAYER argues that since it offered evidence that all of the platforms it purchased were available for sale,⁶ the exemption

⁶ One issue inspired by this dispute, albeit not confronted directly by the parties until TAXPAYER hinted at it in its reply brief (*see* TAXPAYER's Reply, p. 4), is the appropriate interpretation of Department rule 306(a)'s provisions that property purchased by a retailer is exempt from use tax "provided that the tangible personal property is carried as inventory on the books of the retailer or is otherwise available for sale during the interim use period." 86 Ill. Admin. Code § 150.306(a)(1)-(2). Does the disjunctive "or" mean that *either* activity is sufficient to claim the exemption, or were the words "otherwise available for sale" intended to clarify what the Department meant by the phrase "carried as inventory on the books of the retailer".

must apply to the platforms it bought and put into its rental fleet. *See* TAXPAYER’s Brief, pp. 9-11. In its reply, TAXPAYER goes further, and argues that its depreciation of the equipment it purchased and put into its rental fleet is immaterial to the issue of interim use, so long as that equipment was always available for sale. TAXPAYER’s Reply, pp. 3-4.

To support its argument that property can be depreciated yet still be available for sale, TAXPAYER points out that the Internal Revenue Service allows persons in the rent-to-own industry to depreciate the tangible personal property they lease to others. TAXPAYER’s Reply, p. 3 (*citing* Rev. Rul. 95-52, 1995-2 C.B. 27). Specifically, TAXPAYER asserts that “[u]nder a rent-to-own contract, the lessee has the right to purchase the equipment at any time and, if it makes all the required periodic payments, will own the equipment at the conclusion of the lease term. Although the equipment is always available for sale and, under the Retailers’ Occupation Tax, is treated as a conditional sale, its availability for sale at all times does not preclude its qualifying for

The latter alternative seems most consistent with legislative intent, since the former would allow any person engaged in the business of leasing tangible personal property to escape, completely, use taxation regarding the property they use in Illinois, merely by introducing evidence to show that, regardless of how the property was being used by the lessor, the property was nevertheless always available for sale to whomever wanted to purchase it. The legislature certainly did not intend such a result, nor have Illinois courts upheld such an interpretation of the use tax act as applied to persons engaged in the business of leasing tangible personal property to others in Illinois. *See Telco Leasing, Inc. v. Allphin*, 63 Ill. 2d at 310; *Howard Worthington, Inc. v. Department of Revenue*, 96 Ill. App. 3d 1132 (2d Dist. 1981).

The UTA, like the ROTA it complements, was designed to apply to all merchants and consumers who, as a matter of course, would have varying degrees of sophistication, education and experience. *See Pressed Steel Car Co. v. Lyons*, 7 Ill. 2d 95, 105 (1955). The words “carried as inventory on the books of the retailer” has a specific meaning to persons sophisticated in accounting. *See* 26 C.F.R. § 1.167(a)-2. To those with less experience with the intricacies or parlance of accounting, the more commonly understood phrase “otherwise available for sale” provides an alternate description of the same kind of activity the Department would refer to when determining whether a purchaser was either: (1) “using” property as a lessor or other user or consumer; or (2) exercising an “interim use” of the property as a retailer.

depreciation under I.R.C. Section 167.” TAXPAYER’s Reply, p. 3.

One faulty premise in TAXPAYER’s syllogism is its assertion that, under the ROTA, rent-to-own transactions are treated as conditional sales. That is not necessarily so. Generally, conditional sales are “[t]ransactions whereby the possession of the property is transferred but the seller retains title as security for payment of the selling price” 35 **ILCS** 120/1 (definition of “sale at retail”); 86 Ill. Admin. Code § 130.201(a)(1); *see also* 810 **ILCS** 5/1-201(37) (definition of “security interest”). Whether a particular agreement constitutes a lease or a conditional sale depends on the terms and the economic effect of the agreement itself. In re Lerch, 147 B.R. 455, 457, 460 (C.D.Ill. 1992) (*citing* Lathrop v. Bell Federal Savings & Loan Assoc., 68 Ill. 2d 375 (1977)).

Department rule 130.2010 describes, as one example of a conditional sale, a transaction which “involves a lease with a dollar or other nominal option to purchase. Such a transaction is considered to be a conditional sale *from the outset*, and all of the receipts from the transaction are subject to Retailers' Occupation Tax.” 86 Ill. Admin. Code § 130.2010(a) (emphasis added). Another transaction which would ordinarily be considered a conditional sale would be an agreement, nominally identified as a lease, whose terms required the lessee to purchase the goods after the lease period. Swift Dodge v. Commissioner of Internal Revenue, 692 F.2d 651, 653 (9th Cir. 1982); In re Lerch, 147 B.R. at 458-460 (containing an extensive discussion of 810 **ILCS** 5/1-201(37)).

That the IRS treats “rent-to-own contracts ... as leases (not as sales) for federal income tax purposes” was a fact clearly stated in the ruling TAXPAYER referred to in its reply brief. *See* TAXPAYER’s Reply, p. 3 (*citing* Rev. Rul. 95-52, 1995-2 C.B. 27[;1995

IRB LEXIS 265, *1)). That same revenue ruling, moreover, referred to the revenue procedure the IRS published to announce, *inter alia*, that it would treat rent-to-own contracts as leases for federal income tax purposes. Rev. Rul. 95-52, 1995-2 C.B. 27, 1995 IRB LEXIS 265, *1 (*citing* Rev. Proc. 95-38, 1995-2 C.B. 397). Specifically, section 2.07 of Revenue Procedure 95-38 provides:

In a typical rent-to-own transaction, a rent-to-own dealer enters into a contract with an individual for the use of consumer durable property for a period of not more than three years. The individual is under no legal obligation to make all the scheduled payments under the contract, but may acquire the property if all the payments are made. Typically, a substantial portion (and in many cases, a majority) of a rent-to-own dealer's contracts terminate with the return of the property of the rent-to-own dealer.

Rev. Proc. 95-38, 1995-2 C.B. 397; 1995 IRB LEXIS 270, *2. Section 3 of Revenue Procedure 95-38 defines the terms “rent-to-own dealer”, “consumer durable property” and “rent-to-own contract.” *Id.* (§ 3).⁷

⁷ Specifically, section 3.03 of Rev. Proc. 95-38 provides that a “rent-to-own contract”:

- (1) is a contract between a rent-to-own dealer and a customer who is an individual;
- (2) is for the use of an item or items of consumer durable property;
- (3) is titled "Rent-to-Own Agreement" or "Lease Agreement with Ownership Option," or uses other similar language;

* * *

- (6) provides that legal title to an item of consumer durable property remains with the rent-to-own dealer until the customer makes all the weekly, or monthly, or early purchase payments required under the contract to acquire legal title to the item of property;

* * *

- (8) provides for level payments within the 156- week or 36-month period that, in the aggregate, generally exceed the normal retail price of the consumer durable property plus interest;

* * *

- (10) provides that the customer does not have any legal obligation to make all the weekly or monthly level payments set

Even before the IRS published Revenue Procedure 95-38 to announce that it would treat rent-to-own transactions as leases for federal income tax purposes, the Department received a request for a private letter ruling from a person who had opened a rent-to-own business in Illinois. Private Letter Ruling 90-0188 (May 4, 1990). The taxpayer submitted one of its standard rent-to-own contracts, and asked the Department to render an opinion regarding its potential use tax and/or ROT obligations thereunder. Private Letter Ruling 90-0188 (May 4, 1990). In response, the Department wrote, in part:

Please be advised that the Department is of the opinion that your rental agreement constitutes a true lease and not a conditional sales contract. That opinion is based on the fact that the lessee is not obligated to purchase and may terminate the rental agreement at any time without further obligation or penalty, by returning the items to you and making all lease payments through the date of the return.

According to Illinois law, lessors of tangible personal property incur Use Tax liability when they purchase their rental property. See, 86 Ill. Adm. Code 130.2010. Because your rental agreement is deemed to be a true lease, you incur Use Tax liability on your purchase of rental inventory. Your rental receipts are not subject to Retailers' Occupation Tax liability.

Again our determination is based on the Home Appliance Rental Agreement which was appended to your letter. ***

Private Letter Ruling 90-0188 (May 4, 1990).

TAXPAYER cited no authority for its asserted premise regarding the effect of

forth under the contract, and that at the end of each week or month the customer may either (a) continue to use the consumer durable property by making the next weekly or monthly payment, or (b) return such property to the rent-to-own dealer in good working order, in which case the customer does not incur any further obligations under the contract and is not entitled to a return of any payments previously made under the contract;

Rev. Proc. 95-38, 1995-2 C.B. 397 (§ 3.03); 1995 IRB LEXIS 270, **2-5.

Illinois law on rent-to-own contracts. After considering the provisions ordinarily found in such contracts (*see* Rev. Proc. 95-38, 1995-2 C.B. 397 (§ 3.03)), I find no authority to support the premise. As lessors, and not sellers, of tangible personal property, persons engaged in a rent-to-own business in Illinois would be subject to use tax regarding (and would most likely depreciate) the tangible personal property they purchased for rental to others. Telco Leasing, Inc., 63 Ill. 2d at 309-10; Howard Worthington, Inc. v. Department of Revenue, 96 Ill. App. 3d 1132 (2d Dist. 1981); *see also* Rev. Proc. 95-38, 1995-2 C.B. 397 (§ 6); Rev. Rul. 95-52, 1995-2 C.B. 27 (describing how depreciation allowance for consumer durable property subject to rent-to-own contracts is determined).

More importantly, and regardless whether contracts used in the rent-to-own industry could possibly be considered conditional sales contracts, the books and records TAXPAYER introduced at hearing show that *its* rentals are not conditional sales transactions. TAXPAYER's standard rental contract is clearly identified as a "rental agreement". Taxpayer Ex. 6 (TAXPAYER rental agreement). TAXPAYER's rental agreement contains boxes in which TAXPAYER would identify the specific make, model and serial number of the platform being rented, whether the rental rate charged is based on a daily, weekly or monthly rental period, and the starting and ending dates of that rental period. *Id.* (front side of rental agreement). There are no provisions in that contract which expressly grant the renter an option, or a duty, to purchase the rented equipment at the end of the rental period. There are simply no terms included within the four corners of TAXPAYER's rental agreement from which it might be objectively discerned that TAXPAYER or its renter desired or intended to transfer title to, or ownership of, the equipment being rented *as a condition of that rental agreement*. Taxpayer Ex. 6. Again,

TAXPAYER's books and records show that it is primarily engaged in the business of renting, and not selling, the equipment in its rental fleet.

TAXPAYER also cited to Riss & Co., 23 T.C.M. (CCH) 1113 (1964) in its reply, to argue that an item of property could be both subject to depreciation and still available for sale. TAXPAYER's Reply, pp. 3-4. In that case, Riss & Co ("Riss") and another person purchased a damaged DC-4 aircraft, intending to have it repaired, and then to sell it for a profit. 23 T.C.M. at 1154. Riss was not an aircraft dealer (*see* 23 T.C.M. at 1117 ("At all times here material Riss ... was common carrier engaged in motor freight transportation in interstate and intrastate commerce")), and it purchased the aircraft as a purely speculative joint venture. *Id.* at 1154. After Riss purchased the aircraft and while it was being refurbished, the bottom fell out of the market for such aircraft. *Id.* at 1155. In an attempt to offset its investment, Riss advertised the aircraft for sale or lease on or about January 1, 1954. *Id.* Riss subsequently entered into a lease agreement with an airline carrier for the use of the aircraft, on or about August 12, 1954, and eventually sold it. *Id.* at 1155-56.

The pertinent issue in Riss & Co. involved the date on which the taxpayer started to hold the aircraft for the production of income. Riss & Co., 23 T.C.M. at 1158 ("Petitioner [Riss] computed depreciation on the DC-4 from January 1, 1954, whereas the respondent [the IRS] determined that depreciation should begin not later than August 12, 1954, when the airplane was put into productive use"). The tax court held:

Section 167 of the Internal Revenue Code of 1954 permits deductions for depreciation of property used in the trade or business, or of property held for the production of income. **Although the airplane was not used by petitioner [Riss] in its trade or business it was, as respondent has determined, held for the production of**

income. The question is, first, when it became so held by petitioner. It was originally acquired by petitioner and Daly for the purpose of resale for profit and later was held for the production of income by petitioner from January 1, 1954, the time it was first offered for sale or lease by him.

Riss & Co., 23 T.C.M. at 1158 (emphasis added).

What the decision in Riss & Co. actually shows is the difference between the general rule regarding depreciation (*see* 26 C.F.R. § 1.167(a)-1(a)), and the exception to that general rule as it pertains to property which is part of a person's "inventory" or "stock in trade." Treasury Regulation § 1.167(a)-1 sets forth the general rule regarding depreciation. 26 C.F.R. § 1.167(a)-1. That rule provides, in part:

(a) Reasonable Allowance. Section 167(a) provides that a reasonable allowance for the exhaustion, wear and tear, and obsolescence of property used in the trade or business or of property held by the taxpayer for the production of income shall be allowed as a depreciation deduction. The allowance is that amount which should be set aside for the taxable year in accordance with a reasonably consistent plan (not necessarily at a uniform rate), so that the aggregate of the amounts set aside, plus the salvage value, will, at the end of the estimated useful life of the depreciable property, equal the cost or other basis of the property as provided in section 167(g) and §1.167(g)-1. An asset shall not be depreciated below a reasonable salvage value under any method of computing depreciation. However, see section 167(f) and §1.167(f)-1 for rules which permit a reduction in the amount of salvage value to be taken into account for certain personal property acquired after October 16, 1962. See also paragraph (c) of this section for definition of salvage. The allowance shall not reflect amounts representing a mere reduction in market value. ...

26 C.F.R. § 1.167(a)-1(a). Treasury Regulation § 1.167(a)-2 provides:

The depreciation allowance in the case of tangible property applies only to that part of the property which is subject to wear and tear, to decay or decline from natural

causes, to exhaustion, and to obsolescence. **The allowance does not apply to inventories or stock in trade**, or to land apart from the improvements of physical development added to it. The allowance does not apply to natural resources which are subject to the allowance for depletion provided in section 611. No deduction for depreciation shall be allowed on automobiles or other vehicles used solely for pleasure, on a building used by the taxpayer solely as his residence, or on furniture or furnishings therein, personal effects, or clothing; but properties and costumes used exclusively in a business, such as a theatrical business, may be depreciated.

26 C.F.R. § 1.167(a)-2 (emphasis added).

In Riss & Co., the aircraft was eligible for depreciation because Riss held it for the production of income. Riss & Co., 23 T.C.M. at 1158. However, had the aircraft been part of Riss's inventory, or part of its stock in trade, the result surely would have been different because of the "well-settled law that the Section 167 allowance for depreciation does not apply to inventory or stock in trade." Valmont Industries, Inc., 73 T.C. 2935, 2950 [Dec. 36,818] (1980); W.R. Stephen Co. v. Commissioner of Internal Revenue, 199 F.2d 665, 669 (8th Cir. 1952) (cars used as demonstrators or those used by dealership personnel before they were sold were not entitled to depreciation); *see also* Humphrey Cadillac & Olds v. Department of Revenue, 68 Ill. App. 3d 27 (2d Dist. 1979) (cars purchased by auto dealership, which were carried by dealership as inventory available for sale and never depreciated, were entitled to interim use exemption from use tax, even though dealership rented cars prior to selling them).

Here, TAXPAYER, as a manufacturers' distributor, is engaged in the business of selling new aerial lift platforms, and it carries those platforms on its books as its inventory of "equipment held for resale." Taxpayer Ex. 7, pp. 3, 6, 8; Taxpayer Ex. 8, pp. 4, 10. TAXPAYER is also engaged in the business of renting aerial work platforms, and

TAXPAYER depreciates its entire fleet of rental platforms. TAXPAYER, however, is not entitled to an allowance for depreciation of the equipment it rents because “all of it is available for sale” *See* TAXPAYER’s Reply, p. 4. Rather, it is entitled to a reasonable allowance for depreciation regarding the equipment in its rental fleet because it placed that equipment into service (i.e., it *used* it) in its business of renting aerial work platforms to others. Taxpayer Ex. 7, pp. 3, 6, 8; Taxpayer Ex. 8, pp. 4, 10; 26 C.F.R. § 1.167(a)-1(a).

I agree with TAXPAYER when it argues that it is “completely appropriate to depreciate the [rental] equipment.” TAXPAYER’s Reply, p. 4. What I cannot agree with is TAXPAYER’s claim that its depreciated rental equipment is not subject to Illinois use tax. TAXPAYER’s depreciation of the property at issue here acts as an admission that it used that equipment in its rental business, and that it did not purchase that property with the primary intent of holding it for resale. The facts set forth in TAXPAYER’s books and records are more reliable than its officer’s conclusory testimony that all of the platforms in TAXPAYER’s rental fleet were always available for sale, and are more probative to show how TAXPAYER actually treated the equipment at issue. SEE A.R. BARNES & CO. V. DEPARTMENT OF REVENUE, 173 ILL. APP. 3D 826, 833-35 (1ST DIST. 1988).

More importantly, TAXPAYER has cited to no case in which an Illinois court held that a taxpayer’s depreciation of property was immaterial to its claim that the same property was subject to the interim use exemption. To the contrary, in L & L Sales & Services, Inc. v. Department of Revenue 68 Ill. App. 3d 329, 332 (4th Dist. 1979), the Illinois appellate court expressly held that “[taxpayer’s] practice of accounting for the equipment as inventory and not depreciating it is consistent with a continued intent to

ultimately sell it at retail.” In Humphrey Cadillac & Olds v. Department of Revenue, 68 Ill. App. 3d 27 (2d Dist. 1979), the court held that cars purchased by a car dealership and placed into a rental account, “were purchased for the purpose of resale, and that the [dealership’s] transitional use of the cars for rental, courtesy and demonstration was merely incidental. *The most important fact compelling this conclusion is that the cars held under the ‘rental account’ were treated as inventory available for sale at all times.*” Humphrey Cadillac, 68 Ill. App. 3d at 29 (emphasis added).

The fact that the courts in Humphrey Cadillac and L & L Sales felt compelled to address the fact (or the claim) that the property on which tax was assessed was (or was not) depreciated flies in the face of TAXPAYER’s argument that depreciation is immaterial to a determination of use or interim use. Depreciation is relevant and material to an interim use question because only retailers are entitled to claim the exemption in the first place, and because retailers, as a matter of law, are not entitled to claim depreciation on the items of tangible personal property they purchase and include within their inventory of goods available for resale, or as their stock in trade. *Compare 35 ILCS 105/2 with 26 C.F.R. § 1.167(a)-1 and § 1.167(a)-2.* A retailer’s depreciation of an item of tangible personal property is an act which is legally inconsistent with the retailer’s claim that it purchased such property primarily for resale to others, or that it did not “use” such property.

Even if TAXPAYER eventually intended to sell the aerial lift equipment it purchased during the audit period and put into its rental fleet, the documentary evidence shows that TAXPAYER primarily intended to exercise power and control over that property by making it available for rental to customers in Illinois, and in fact, exercised

such power and control over that equipment. That exercise, incident to TAXPAYER's ownership of the equipment, is a use of such property. 35 ILCS 105/3; Telco Leasing, Inc., 63 Ill. 2d at 310. I conclude that TAXPAYER was primarily a lessor of the aerial lift equipment in its rental fleet, and that it is subject to the use tax assessed here.

Conclusion:

TAXPAYER has not rebutted the *prima facie* correctness of the Department's determination to assess use tax on TAXPAYER's purchases of the aerial lift equipment it purchased and made available for rental to others. TAXPAYER has not shown that it exercised only an interim use of that equipment. Therefore, I recommend the Director finalize Notice of Tax Liability no. XXXX as issued, with interest to accrue pursuant to statute.

Date Issued

Administrative Law Judge